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Material Participation: Social Security, Federal Estate, and Income Tax Planning

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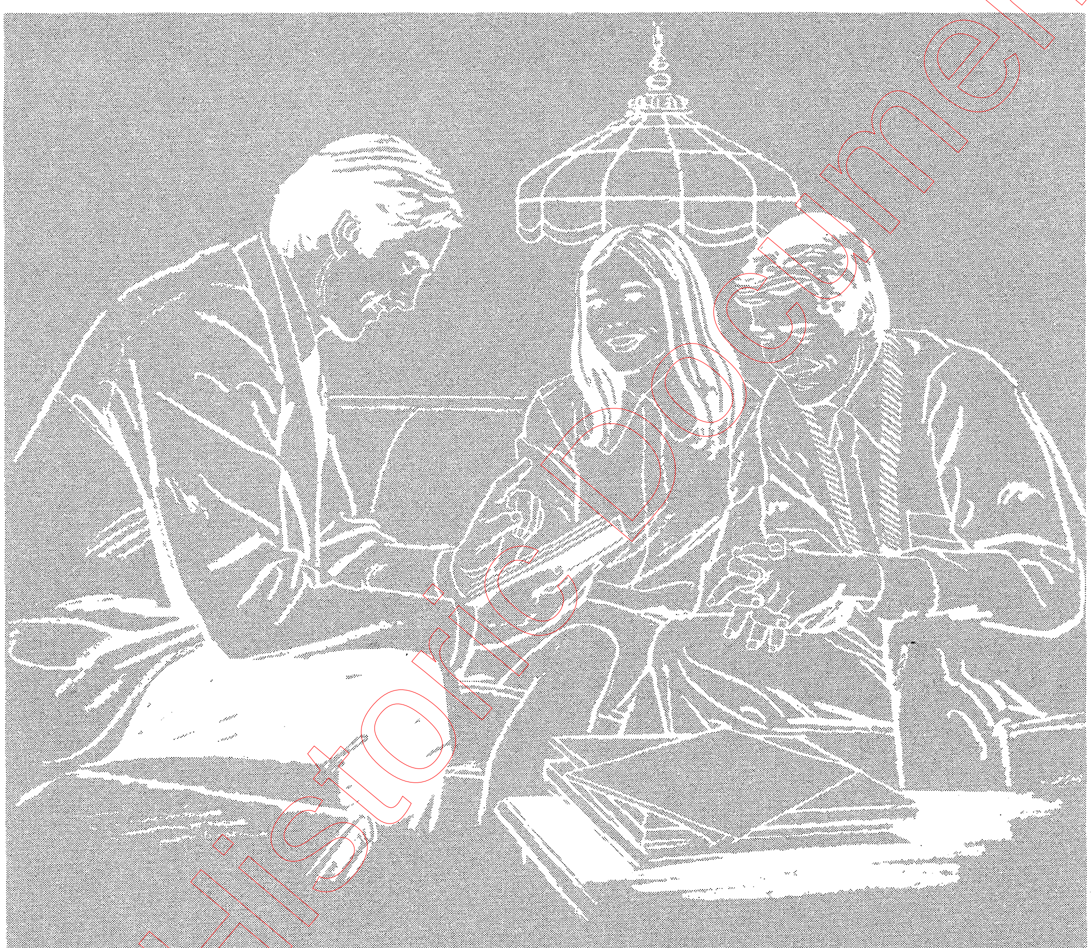

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Disclaimer: This paper is intended as an educational aid in your estate and retirement planning. Legal Counsel is advised for assisting in developing and drafting your estate plan and should be considered before discussing your retirement and business affairs with a government agency.

Material Participation: Social Security, Federal Estate, and Income Tax Planning

Gerald A. Harrison*

Introduction

The Tax Reform Act of 1976 included a provision for special use valuation of farmland for federal estate tax purposes. One of several requirements for qualifying for the special use valuation is that the decedent's farmland was operated by the decedent or a family member in an arrangement meeting a test of material participation. Also, the family members who inherit the land and elect special valuation must meet the test of material participation beginning at the date of death.

However, the Economic Recovery Tax Act of 1981 (ERTA) introduced several amendments which modify the requirement for meeting a material participation test. For example, farmland owners may retire or become disabled and personally cease material participation, yet their land could be eligible for special valuation in their estate. This could be true even though no family member was participating in the decedent's behalf. The 1981 Act also modified the nonpassive business requirement of the "qualified use" test in a way to make qualifying for special valuation easier for certain family rental situaions.

Since special use valuation of farmland for estate tax purposes may be based on a capitalization of cash rents observed for farmland comparable to that in the decedent's estate with the Federal Land Bank interest rate, it is readily apparent to those familiar with current farmland prices that this valuation provision will give "use values" of about 40 to 50 percent of fair market values.

Material participation and its many applications are not generally understood. The meaning of material participation for purposes of estate tax special use valuation is borrowed from self-employment (social security) tax on rental earnings. Individuals with active or materially participating income must pay self-employment tax. In the case of individuals drawing social security benefits, a rental obtained in a materially participating lease above an annually exempt amount will bring a forfeiture of social security benefits. The presence or absence of a material participation lease has significant implications in several situations under federal tax law. In retirement and estate planning, it is more important now than in the past to understand the essential ramifications of material participation.

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Material Participation and the Self-Employment Tax

An individual must have worked long enough under the social security rules either as a covered employee or as a self-employed to be entitled to social security benefits. Covered income from employment or self-employment is subject to social security or self-employment tax. This discussion emphasizes the problems of a farmland owner who rents his land.

Farm income does not count for social security purposes unless under the leasing arrangement, the farm landlord "materially participates" in the actual production of the farm commodities or in the management of production. For purposes of defining the presence or absence of material participation for social security purposes, "landlord" means any leasor regardless of whether the land is owned or subleased from someone else. For example, a family member might rent from a parent and then sublease it to a tenant, and if desired, the family member could establish a materially participating lease with the operating tenant. The participating family member would be eligible and, in fact, required to pay self-employment tax on net earnings. As explained below, it is this type of arrangement that some farmland owners will wish to establish in their retirement years in order to be entitled to their full social security benefits while avoiding paying additional self-employment tax and at the same time satisfying the qualified use and the material participation requirement of special use valuation for federal estate tax.

What does materially participating mean? A landowner (leasor) or renter is "materially participating" if:

(1) The rental arrangement provides for the landowner to take a significant part in the production or management activities involved in producing the farm commodities, and

(2) The landowner actually takes part in the production or management activities to the extent described in any one of four tests to be outlined below.

While each case is determined on its own facts, past court cases and present regulations have produced four tests as "safe harbor" conditions for satisfying the material participation requirement. Generally, if any one of the four tests is satisfied, material participation is present for social security purposes.

<u>Test I</u>

Test I is satisfied if an individual (leasor) does any three of the following:[1]

(a) Inspect the production activities periodically; the number of inspections required will be decided in relation to the size and kind of farm. Inspections during the plowing, planting, cultivating and harvesting operations count; mere inspection of the property do not.

(b) Consult and advise with the tenant periodically. Advice to and consultation with the tenant concerning how farm commodities are to be produced is what is envisioned here. The acceptable activities here are the same as (a) above: fertilizing, planting, cultivating, harvesting, as well as marketing.

(c) Provide at least one-half the equipment, tools and livestock used in farm production. It is possible to satisfy this part of the test with less than half, depending upon the facts.

(d) Provide at least 50 percent of the direct costs of producing the crop. (Perhaps as little as 20 percent of such costs could meet this part of the test depending upon the facts.) Costs envisioned for this part of the test are fertilizer, seed, fuel, machinery repair, pesticides, herbicides and other supplies used directly in production. For this item, the value of labor sup-

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[1]From HEW publication No. 78-1006 available in any Social Security Office. Social Security field staff have indicated their operations manual provides that only two of the four are necessary to satisfy Test I, but one of the two must be nonfinancial in character. Presumably, if (a) or (b) are satisfied then (c) or (d) would be sufficient.

plied by the tenant and overhead expenses such as taxes and depreciation do not count in determining the percentage provided.

Test II

This test is satisfied by making decisions on a regular and frequent basis which significantly affect the success of the farm operation. The social security guidelines suggest that decisions which count include when to plant, cultivate and harvest a crop. Only deciding on which livestock and crops to raise or where to plant will not suffice for this test.

Test III

You may be deemed to be materially participating if you take part in work on the farm under the rental agreement of at least 100 hours spread over 5 or more weeks on activities connected with crop production

The nature of the work considered here includes repair work on farm buildings, fences and equipment used in crop and livestock production, record keeping, as well as work in the direct production process: purchasing, planting and harvesting.

It is important to note that work performed that will satisfy this test must be spelled out in the lease arrangement. Work performed as a result of a separate agreement with your tenant to work as a part-time employee will not count.

Test IV

Material participation may be achieved when all activities of the landlord are taken together, even though each of the three tests above are not satisfied when considered separately. A social security representative can offer a judgment as to whether a particular arrangement will or a set of activities along with a lease arrangement has satisfied a material participation test. It should be recognized that the judgment of social security office field staff may not be the final word. The decision of an administrative agency such as the Social Security Administration or the Internal Revenue Service may be challenged by following certain procedures set out in the law. Where significant social security, estate, or income tax issues are involved legal counsel is advised.

Background. Material participation was introduced as a legislative requirement in 1956, when Congress amended the law to allow materially participating landlords to have their rental income counted as social security earnings for self-employment tax purposes. The accepted definition of material participation is in part the result of several court cases concerning disputes over material participation and whether a landlord in a given situation was entitled to pay self-employment tax on rental income, and thereby earn social security benefits. IRS Revenue Rulings and Regulations defining the conditions for material participation also followed.

One development of case law after 1956 was that management agents for landlords could materially participate on behalf of the landlord. The IRS issued a Revenue Ruling to this effect in 1964. This adjustment in the law surrounding material participation for landowners seemed consistent with what other self-employed persons outside farming might be permitted in the operation of their trade or business. That is, they employed agents to help efficiently manage their property interest, yet the income from such business would still be considered "earned income" for self-employment tax purposes.

In 1974, Section 1402(a)(1) of the Internal Revenue Code and corresponding Social Security law regarding what would be considered as earned income by landlords with materially participating share leases was dramatically amended. The amendment which was effective January 1, 1974 said, in short, that management agents through conventional farm management arrangements with landowners would no longer be deemed to materially participate on behalf of the landowner. Thus, the rental income obtained through a share lease (with landowner responsible for a significant share of the crop and livestock costs and perhaps retaining veto power over farm activities) would no longer be considered as "social security income" on which self-employment tax was required and because of which social security benefits could be lost.

Wilbur Mills, at that time chairman of the House Ways and Means Committee, summarized the intent of the 1974 Amendment in this way:

> The Amendment is limited to excluding farm rental income only in instances in which the landowner completely turns over the management of his land to an agent, such as a professional farm management company and does not materially participate in the farming operation himself on that land.

Further, Mills explained that it was now the policy of the nation not to levy a self-employment tax on what a landowner wanted to be investment income rather than income from self-employment.

While the 1974 Amendment seems logical in retrospect, it may have been a very fortuitous measure for landowners who may have achieved material participation with the involvement of a farm management agent as the law permitted from 1956 through 1973. These individuals may have been able to get the better of both worlds without substantially modifying their professional farm management arrangement; first, a right to pay self-employment tax on rentals and thereby earn social security benefits and second, to retire and by virtue of the new rule starting in 1974, no longer be required to pay self-employment tax on rentals and also avoid the possibility of losing social security benefits in a given month or year because of earned income above allowable exemptions. However, in light of the apparent importance of special use valuation as a potential estate tax saver by permitting reduction in farmland valuation of as much as $500,000 for a given estate, the need for and widespread employment of professional farm managers by landowners raise a special concern in some situations. That is, can individuals who are not capable of managing or who may wish to retire from an active management role of their land utilize the services of a professional farm manager and still achieve material participation? It is clear, as indicated by recent IRS regulations, that landowners may employ a professional manager to assist in certain management functions as a consultant and still meet one or more of the tests of material participation.

<u>Final Regulations-July 31, 1980.</u> The definition of material participation for use valuation is mandated by the Tax Reform Act of 1976 to be similar to the concept as it was already defined for self-employment tax and purposes. To bring the material participation regulations up-to-date and to illustrate the United States Treasury's view of the role of material participation for self-employment tax and special use valuation purposes, the Internal Revenue Service issued final Regulations on July 31, 1980. For one, these new regulations for the first time updated the Regulations for the Internal Revenue Code (IRC) in a way to be consistent with the 1974 amendment to the IRC on management agents and material participation.

Among the examples added to IRC Regulations [Section 20.2032A-3(g)] on material participation was one showing how a management agent can be employed yet the landowner still achieved material participation. This illustration appearing in the <u>Federal Register</u>, Vol. 45, 149, Page 50741 (Thursday, July 31, 1980) is as follows:

> Example (4). F, a qualified heir, owned a specially valued farm. He contracted with G to manage the farm for him as F, a lawyer, lived and worked 15 miles away in a nearby town. F supplied all machinery and equipment and assumed financial responsibility for the expenses of the farm operation. The contract

> specified that G was to submit a crop plan and list of expenses and earnings for F's approval. It also called for F to inspect the farm regularly and to approve any expenditures over $100. In practice, F visited the farm weekly during the growing season to inspect and discuss operations. He actively participated in making important management decisions such as what field to plant or pasture and how to utilize the subsidy program. F is deemed to have materially participated in the farm as his personal involvement amounted to more than managing an investment. Had F not regularly inspected the farm and participated in management decisions, however, he would not be considered to be materially participating. This would be true even though F did assume financial responsibility for the operation and did review annual crop plans.

The agent (G) was performing services while the qualified heir was involved in important decisions, inspected routinely and supplied all equipment and machinery and assumed financial responsibility for the expense of the farm.

In reviewing this illustration with IRS personnel, it was further explained that the manager (G) was, in fact, conceived to be running the production activities through employees of the management firm. The statement that all machinery was provided by the owner is not typical for tenant operations in the Midwest. IRS personnel indicate that a third party tenant could be providing the machinery and running the farm operation; yet the landowner could materially participate and have the assistance of a professional farm manager. The key is whether the landowner personally satisfies the material participation tests described above.

Material Participation and Social Security Retirement Tests

The possible dilemma of the interplay of the material participation requirement for use valuation and social security retirement tests and the social security (self-employment) tax need to be fully exposed. Where the "typical" family farm situation exists, with continuity of generations who are directly involved in the farming business, the material participation requirement for estate tax special use valuation should not present a problem. This advantage will carry over when we consider the possible problems that a social security retirement presents when a retiring farmland owner wishes to qualify land for use valuation.

<u>Annual Retirement Test</u>. When a person covered by social security wishes to retire and begin collecting full benefits, there is a requirement to substantially, if not completely, retire from active employment or self-employment. A person who continues to have earned income either as an employee or as a self-employed will lose social security benefits if the earned income under the annual test surpasses a certain annually exempt amount--in 1981 $5,500 if age 65 or over, unless the retiree has reached age 72 (age 70 in 1983) at which time earned income no longer limits social security benefits. The annually exempt amount for those 65 and over rises each year to $6,000 in 1982 and after 1982 increases will be automatic--based on changes in the cost-of-living index.

For each $2 earned above the allowable exempt amount, $1 of social security benefits will be lost when the annual test applies. Under the annual test in 1981 a retiree with a $7,500 social security benefit who earns $20,000 from a materially participating rental arrangement and/or from any other source of earned income would give up the entire social security benefit for the year [$20,500 - $5,500 = $15,000]. The

$15,000 is referred to as excess earnings. One dollar of benefit is lost for each $2 of excess earnings. Thus, the total $7,500 benefit is lost. For figuring earnings for purposes of the retirement test, all wages as an employee and net earnings from self-employment minus any net loss from self-employment for the year are summed together. The retirement test is on a taxable year basis, and everyone is assumed to be on a calendar year unless the individual establishes otherwise.

Monthly Retirement Test. Except for the year of initial retirement under social security, the monthly test has been replaced by the annual test as a result of a change in the social security law effective January 1, 1978. Actually, the monthly test applies only in the first year in which there is a month in which the individual does not earn over a monthly exempt amount which is 1/12 of the annually exempt amount ($458 in 1981) as an employee and does not perform "substantial services" in self-employment. Both the annual and monthly tests apply in this initial year of retirement. If a social security retiree has one or more months in a year prior to full retirement in which earnings are not more than the monthly exempt amount and does not render substantial services in self-employment, the monthly test will apply to that year and cannot be applied again in a subsequent year. If benefits are not applied for on the first month of a taxable year (usually calendar year), the earnings for that taxable year prior to the month benefits start must be counted toward total earnings for the year.

Whether one has performed substantial services in self-employment depends upon the Social Security Administration's evaluation of certain factors: (1) amount of time devoted to the business in a month, (2) how this amount of time compares with pre-retirement involvement, (3) nature of services rendered, (4) presence or absence of an adequately qualified paid manager or partner or family member who manages and/or operates the business, (5) type of business involved, (6) capital invested in the trade or business, and (7) seasonal nature of the business.

Time spent in work includes time devoted to planning and management as well as physical work. Of course, the type of activities required of a landowner to materially participate in a leasing arrangement would be the type of services in self-employment of concern for the monthly test. Failure to respond to Social Security Administration's request for information regarding services in self-employment is sufficient basis under the rules for a determination that substantial services were rendered during the period in question.

The general guideline is that if such work in a given month amounts to 45 hours or more this is taken to be substantial services. While, if the amount is fewer than 15 hours this is not considered substantial. Between 15 and 45 hours is a "gray area" with the decision by Social Security depending upon their evaluation of the factors discussed above. For example, the more highly skilled the work is, the more likely less than 45 hours of service could be interpreted as substantial. The 45-hour rule generally holds for farmers. Practitioners have indicated no challenges have been made of their farmer clients under 45 hours of work.

There is considerable caution exercised by the social security field staff with regard to "dubious retirements." Suspicions are aroused most readily in closely-held business situations where social security benefits are sought under a declared retirement, but it is less than clear that the "retiree" has, in fact, withdrawn from the effective management of the business. Closely-held corporate arrangements may be held in suspicion by social security staff especially when the corporation is formed just before retirement. Retirees may attempt to shift what was salary income to dividend income. This is generally acceptable unless no new employee or rearragement of employees takes up the activities previously performed by the retiree. The retired employee-stockholder can reduce employment and salary to a few hours to be below the annual (or monthly) exempt amount, but the question in Social Security's examination of effective retirement becomes: Is the retiree still performing or accomplishing pre-retirement tasks? This is a difficult area in which to make judgments since an individual is both management and labor. The labor contribution may stop or be substantially reduced, but the valuable input of management by the retiree is often expected to continue. Very little time may be required to perform significant management services. The "gray area" between 15 and 45 hours of services can be of concern to the social security field staff. Where a retiree is returning for "limited service" as an employee in a family business, the suspicion may be that the retiree is significantly undercompensated and, in effect, transfers the income to other family members who are then over-compensated or the retiree hopes to gather what was or could be justifiable salary as dividends or retained earnings in a corporation.

Hours of "substantial service" rather than dollar earnings is the test for individuals who are self-employed such as farmland owners or operating farmers since the self-employed often don't know if they will have a profit (that is, a positive net earnings) for the year. Money actually received in a given month by a self-employed may be from production of a prior period. Thus, for the self-employed, the law considers one retired under a monthly test only if not performing substantial services. In the case of one who is earning as an employee, the test is a simple earnings check.

The advantage of the monthly test is that in any month where there are net earnings above the allowable minimum ($458 in 1981), nor are there substantial services by the self-employed, no social security benefits will be sacrificed. A change in the law implemented an annual test for social security retirement because Congress was convinced that the monthly test permitted many inequitable situations. The monthly test permits social security retirees to control earnings or substantial services to a few months of the year during which or as a result of such services realize significant earnings. For example, a farmer might retire yet work more than 45 hours in a given month in only 3 months of the year yet continue to plant and harvest crops. Under a monthly test he would be able to collect full benefits for 9 months, even with substantial farm income. Similarly, a retiree who has an interest in a profitable closely-held business could return as an employee or management consultant justifiably receiving a high rate of pay in 1 or 2 months and still obtain full social security benefits in all other months. The inequity arose when the retired person who might have an opportunity to work and earn as much as the individuals above, but only by working 12 months out of the year and in so doing would surpass the monthly exempt amount in each month and receive no social security benefits.

Since 1978 the monthly test is applied only in one year, the initial year of retirement. What was routinely done in the past is possible now for up to one year of social security retirement. The monthly test is limited to the remainder of the taxable year in which one effectively retires. If retirement is on June 1 for a calendar year taxpayer, the monthly test is applicable only through December of that year. However, the monthly test will not be applied until one month has elapsed with earned income below the monthly test limit (1/12 of the annually exempt amount, $5,500 in 1981) and substantial services in self-employment were not performed. After retirement under social security has been applied for and the month mentioned occurs, then the balance of the tax year is under the monthly test. It is noteworthy that if a person entitled to social security has one or more months in a year prior to full retirement in which he does not earn more than the monthly exempt amount and does not render substantial services in self-employment, the monthly test will apply to that year and cannot be applied again in a subsequent year.

Because the annual test applies in the initial year of retirement along with the monthly test, no benefits are lost if for the year the annual exemption has not been exceeded even though the monthly limit has been surpassed in one or more months. Only when the annual exemption has been exceeded will any monthly benefits be lost under a monthly test and then only those months in which more than the monthly limit was earned and/or substantial services were performed. For example, if social security benefits are $600 per month and there are excess earnings of $2400, up to $1200 in benefits could be lost under a monthly test. If there are only 2 months in the initial year of retirement in which earnings of an employee exceeding the monthly limit and/or substantial services were performed, then at most, $1200 in benefits would be lost. If there was only one month in the initial year with excess earnings and/or substantial services then only one month--$600--of benefits would be sacrificed. Further, if this were a farmer who had a materially participating lease but did not perform substantial services (less than 45 hours) in any of the months of the initial year, he could receive full social security benefits because of a monthly test in year one of social security retirement.

Listed here is what does not count as earnings for the social security retirement test:

1. Investment income: which includes rental income for solely or jointly-owned property where there's not a materially participating lease arrangement, stock dividends including dividends from subchapter-S corporations (note the discussion above about social security scrutiny of closely held corporations), income from limited partnership interests, certain retirement payments from a partnership. Dividends are not excluded if the retiree deals in securities from which the dividends arise.

2. Interest earnings from savings accounts or CD's.

3. Income from social security benefits, pensions, retirement pay or veterans' benefits.

4. Income from annuities.

5. Return of capital and gain or loss from the sale of capital.

6. Value received as lifetime gifts and inheritance.

7. Royalties received in or after the year of age 65 from patents or copyrights obtained before that year.

8. Due to a change in the law in 1980, all or any part of the income from self-employment received in a taxable year after the year of entitlement (calendar year in which one retires on social security benefits) which is not attributable to services performed after the initial month of entitlement (first month for which you are entitled to benefits in the year of entitlement) may be excluded from gross earnings for annual test purposes for a given taxable year. The 1980 change is effective for taxable years ending after December 31, 1977. This exclusion from the annual test for benefits entitlement purposes does not apply for social security coverage and self employment tax liability purposes (see illustrative cases, page 13).

Listed are various situations to illustrate the operation of the social security retirement tests:

Case 1. A farmer retires effective January 1, 1980, having reached age 65 in December of 1979. He earns $800 in each of May and October during planting and harvesting for a total earnings of $1,600 as a corporate employee. This work might be for a neighbor, but if it is for his family's corporation or one in which the retiree has substantial stock and holds an office, whether the farmer has effectively retired will be carefully scrutinized by the social security field staff as explained above. Since he did not earn more than the 1980 annual test exemption of $5,000 (i.e., no excess earnings), he will be entitled to the full 12 months of social security benefits.

Case 2. Suppose the above retiree worked 6 months (April, May, June, September, October, November) earning a total of $6,500, $1,500 above the 1980 annual exemption of $5,000. He has surpassed the 1980 monthly exemption of $417 in each month that he worked. Losing $1 of benefits for each $2 beyond the annual amount, he will lose $750 of benefits. In this case the benefits beginning with April, will be lost until $750 is returned or foregone, including the benefit that a spouse is entitled to. Thus, if the combined individual and spouse's benefits are $600 a month, they will lose all of April's benefit and $150 of May's benefit. Benefits received for the other six months of the year are undisturbed because the amount forgone under the annual test has been sacrificed in April and May.

In 1981, if this individual earns $6,500 in the same manner when the monthly test no longer applies and the annual exempt amount is $5,500, half of the excess earnings of $1,000 ($500 of benefits) will be sacrificed. Once this retiree reaches age 70 in December 1983, full benefits are payable regardless of active earnings or self-employment status. But as long as there is earned income as an employee or self-employed, social security tax must be paid on earnings subject to the tax. As Table 1 indicates, employer and employee rates are each 6.70 percent and the self-employed rate is 9.35 percent in 1982. The wage base (level of earnings beyond which income is exempt from the annual social security tax) is $31,800.

Case 3. A farmer retires on January 1, 1980. He performs "substantial services" in May, June and October. The net farm earnings from this self-employment (120 acres of corn and beans) is $13,000 after selling his crops in October. The net earnings exceeds the $5,000 annual exemption by $8,000. But since the monthly test is applicable in this initial year of retirement, no benefits will be lost for any month in which no more than $417 was earned nor were substantial services performed. Rather than losing $4,000 in benefits ($1 for each $2 of excess earnings) as would be the case under the annual test, he will lose only the benefits for May, June, and October.

Case 4. The farmer in Case 3 above except he performs no services and does not have a materially participating lease although he has a share lease. He nets $9,000 in this situation. Since there were no substantial services and the income from the rental does not count as "earnings" for retirement tests, monthly or annual, social security benefits are unencumbered and no social security tax is due on the income as in Case 3 where the farmer actually

Table 1. Social Security tax rate, wage base, and maximum contributions: 1979-1982

Years	Tax rate: Employer-employee	Tax rate: Self-employed	Wage base	Maximum tax: E-ER total	Maximum tax: Self-employed
	Percent			Dollars	
1979	6.13	8.10	22,900	2,808	1,855
1980	6.13	8.10	25,900	3,176	2,098
1981	6.65	9.30	29,700	3,950	2,762
1982	6.70	9.35	31,800	4,261	2,973

planted and harvested his own crop as any other self-employed farmer.

Case 5. The situation is similar to Cases 3 and 4 above except the farm landowner has a materially participating lease. He does not reach 15 hours of service in any month. His net earnings from the farm are $9,000 on which self-employment tax must be paid. Since this was the first year of retirement and substantial services were not performed in any of the 12 months, even though over the annual exemptions he will not lose benefits. Since $9,000 is $4,000 more than the $5,000 exemption for 1980, up to $2,000 ($4,000 ÷ 2) in benefits could have been lost if substantial services had been performed.

If the same results repeat in 1981, the second year of retirement, that $9,000 would exceed the $5,500 annual exempt amount for 1981 by $3,500. This means $1,750 of benefits would be lost for 1981. Self-employment tax must be paid on the net earnings.

Potential Problem for Cash Basis Farmers Alleviated. One important problem that farmers who are cash basis taxpayers may face is the sale of products from a self-employment activity in a year following the one in which they were actually produced. This problem was particularly troublesome when the annual test was implemented in 1978. Some farmers who retired in 1977 thought the monthly test would apply until they reached age 72. In some cases crops were carried over from 1977, the initial year of retirement, and sold in 1978. Since 1978 was under the annual test because of a December 1977 amendment to the law, many exceeded the $4,000 annual exemption in 1978, creating excess earnings on the year and requiring a payback of benefits for 1978. If the crop had been sold in 1977 when a monthly test applied, less would have been lost.

This problem was substantially alleviated by a 1980 amendment (Section 3 of P.L. 96-473) to the annual earnings test. The change will affect the annual test for self-employment income arising from farming as a sole proprietor or partner. Also retired insurance salesmen who receive renewal commissions and others who receive net earnings from self-employment (NESE) activity may also benefit because of the change.

In the case of retired farmers, the new amendment permits the sale of a carryover crop after a social security retirement, and not have the net proceeds count as self-employment earnings, if the production of the crop was completed before the initial month of entitlement (MOE). Furthermore, this new provision permits a retired businessman to receive income from the business after they retire and not have this income count as NESE and likewise for retired partners who receive a distributive share of partnership income and not be penalized for such income. Of course, this exemption from inclusion of receipts as NESE requires that the retired party not continue to perform services in the business or partnership.

The intent of the law is to alleviate at least part of the problem outline above by not penalizing self-employed persons for receipts of deferred income (e.g., carryover crop) earned before retirement begins (MOE) in the case of the self-employed farmer and for income received after the year of entitlement which is deferred from the ownership of a business or a partnership share.

For purposes of this new exclusion rule, "services" means any regular services performed in the ongoing operation or management of a trade, profession, or business which can be related to the income received. Further the instructions in the Claims Manual used by social security staff that a beneficiary who retains ownership of a business which is being operated and managed by others must at times take actions to protect his investment. Such actions are not considered as performing services in the operation or management of a trade or business. If a crop or product were produced or created prior to the month of retirement, the actions taken merely to sell that crop or product should not be considered as "services" which would cause the inclusion of such income in the earnings test.

Examples of several activities which are not services in the operation or management of a trade, profession or business:

1. Actions to sell crops or products if the inventory was completely produced by the beneficiary prior to the month of entitlement. Those in the trade or business of buying or selling commodities would not come under this rule.

2. Those activities which are not significant in the actual operation or management of the day-to-day operations of the business such as:

a. Signing a contract to hire a manager to operate the business.

b. Signing contracts where the owner's signature is required so long as the major contract negotiations were handled by the owner's agent or employees.

c. Looking over the company financial records to assess the effectiveness of those agents or employees or managers in running the business for the owner.

d. Personally contacting an old and valued customer solely for the purpose of maintaining good will and would have a minimal effect of the ongoing operation of the trade or business.

These aspects of the new amendment seem to allow a social security retiree substantially more interaction with a trade or business than in the past.

In cases where only a portion of the income received in a year is not related to significant services performed after the MOE, only that portion may be excluded from gross earnings for deduction purposes. The balance of the income counts for deduction purposes.

Illustrative Cases. The following examples of the SE income exclusion dealing with farmers are illustrated in the Claims Manual:

Example 1: Only part of the income in a year is not attributable to "Services" after the MOE and there is a net loss from self-employment: In 1980, a self-employed (SE) farmer received gross income of $40,000. His farm expenses for 1980 were $30,000 and the NESE was $10,000. He establishes that $20,000 of the gross was from the sale of a crop raised in a prior year before his initial MOE, and can be excluded. Excluding the income from the carryover crop reduces the gross to $20,000. Deducting the $30,000 in expenses results in a loss of $10,000, which can be deducted from wages or other income from self-employment if applicable to determine his total earnings for deduction purposes. The $30,000 in business expenses can be deducted because they are in connection with the $20,000 gross actually earned in 1980. None of the expenses are in connection with the carryover crop.

Example 2: A self-employed farmer retired at the end of November 1978. He filed for social security benefits in November 1978. From April 1978 through November 1978 he raised, harvested and stored a grain crop. The crop was sold in 1979 making the net profit from the sale of the grain reportable as NESE for 1979. If the beneficiary requests that the income be excluded, his request can be approved since the income in a taxable year following the year of entitlement and the income is not attributable to services performed after the initial month of entitlement solely in connection with sale of the stored crop; e.g., arranging for the delivering of the crops to a market are not considered services attributable to the income received.

The income from self-employment which is excluded from 1979 total yearly earnings is not counted as earnings for 1978 for deductions. However, the actual net earnings from employment (NESE without income exclusion) subject to SE tax for the year continues to be used for coverage purposes and for any computation of benefits.

Example 3: A self-employed farmer became entitled to benefits in May 1977. He cultivated, harvested and stored a grain crop in the period July through November 1977. He did not work after November 1977. In March 1978 he sold the 1977 holdover crop for $30,000.

In this case, the new income exclusion does not apply even though the income was received in a year following the year of entitlement because the income was due to services performed after the month of entitlement. However, he may still receive benefits in 1978 under the monthly earnings test if he has nonsubstantial service (NS) months in 1978 because 1978 is his initial grace year under the 1980 ammendments even though he had an NS month in 1977.

Example 4: Same as (3) above except $10,000 of the $30,000 gross income is due to the sale of a holdover crop which he cultivated, harvested, and stored prior to his initial month of entitlement. In this case, $10,000 of the total income of $30,000 can be excluded since that portion is directly attributable to a source of income for which significant services were not performed after the month of entitlement. Any activities in connection with the sale of the crop, even though they were performed after the month of entitlement, will be considered conversion actions to turn an asset into a liquid asset rather than services attributable to the receipt of the income.

Example 5: A farmer attained age 65 in October 1980 at which time he had already raised, harvested and stored his grain crop for 1980. He filed for and became entitled to benefits beginning October 1980. He declared that he would not work again until April 1981. Thus 1980 is his initial grace year. Since the farmer gave no indication that he would exceed his annual exempt amount of $5,500 for 1981, his benefits continue. When he files his 1981 annual report, he indicates all months are service months and he has NESE of $10,000. He advises that this income was for the partial sale of his 1980 crop which is excludable. His 1981 crop was stored thus he would not at this time forego any of his social security benefits for 1981. This farmer continues this pattern through 1984, selling $10,000 of his 1980 crop which is excludable each year and storing the current years crop. Each year he would be entitled to his full social security benefit.

Although he has performed services each year after his month of entitlement, he received no income attributable to these services. The income he does receive is the result of his 1980 carryover crop, which was raised, harvested, and stored before his initial month of entitlement. Therefore, each year he can exclude $10,000 from his gross income from self-employment.

If 1986 this farmer sells all of his stored grain which was raised in 1981-84 for $240,000. Since he attained age 70 in October 1985, the earnings test no longer applies and no deductions will be imposed based on his earnings in 1986. While these results are feasible under amended social security rules, the income tax results may make such a strategy prohibitive.

If this farmer had sold the $240,000 inventory of grain in 1985, his earnings for deductions for 1985 would be $185,000. This is arrived at by dividing the $240,000 by 12 and multiplying the result by 9 (the number of months he was under age 70 in 1985). All this income is attributable to a source for which significant services were performed after the month of entitlement, even though the services producing the crop inventory were not performed in the year in which the income was received. Thus if the income was realized before age 70 (age 72 in 1983), it is self-employment income for deduction purposes. Of course, the income is in part subject to self-employment tax.

The Claims Manual also provides illustrations for self-employed insurance salesmen.

A retired partner, under the 1980 amendments, can exclude payments received in a taxable year after his first year of entitlement if the income is not attributable to services performed after the initial month of entitlement. Note that as before the amendment, if payments to a retired partner are classed as a pension under Section 211(a)(9) of the Social Security Act, then they are not reported as NESE.

Partner Example: One of two partners retired of August 31, 1978, at age 65 and became entitled to social security benefits in September 1978. He left capital in a partnership with an agreement to receive a percentage on the profits each year.

For 1978, the retired partner showed $30,000 self-employment income with no substantial services for September through December 1978 he received benefits for September through December 1978 since 1978 was his initial grace year. Under the rules prior to the new amendment, he did not receive benefits for 1979 or 1980 because of substantial NESE. But under the new amendment, promulgated in 1981, the retired partner may sign a statement explaining that he no longer works in the partnership and provided no services after his initial month of entitlement (September 1978).

With these facts, the social security staff can determine, under the new amendment, that the retired partner had no excess earnings for deduction purposes and he may be paid benefits for all the months of 1979 and for the partnership payments and 1981 and thereafter benefits can be on a monthly basis.

The 1980 amendments do not change the law in effect since 1964 regarding exclusion of royalties received which are attributable to copyrights or patents obtained before the taxable year in which the taxpayer attained age 65.

One way the cash basis problem could be avoided is by accrual basis accounting. Few farmers are on the accrual method, but those who are value each year's production if in inventory at the end of the year and add this to income for the year. This income then would be earnings for the retirement tests in the year of production.

Retirement and Estate Tax Special Use Valuation Requirements. With an understanding of the annual test and the self-employment tax law, we can calculate the price a retired person must pay to continue to materially participate either as a landowner and/or as an operating farmer. If retirement under social security rules is desired, material participation and/or substantial services performed may cause the loss of some or all social security benefits, particularly after the first year of retirement. Whether any benefits are lost as a result of material participation in the initial year of retirement depends upon whether substantial services were performed. At age 72 (age 70 in 1983), the retiree can materially participate and earn any amount of self-employment income and not sacrifice social security benefits. Since wages and self-employment earnings are subject to the social security tax at all ages regardless of retirement, the costs and benefits of this tax must be evaluated. Depending upon the amount of past earnings being counted to determine a social security benefit, current earnings subject to social security tax may increase future benefits.

Before one undertakes to materially participate in a leasing arrangement for meeting the requirement for use valuation, any lost benefits and added self-employment tax must be weighed against the expected worth of a lower estate tax to the surviving spouse and heirs.[2] An estimate of the federal estate tax is essential, and this will depend upon the amount of farmland involved. There may

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[2]July 31, 1980 IRS Final Regulations on special use valuation [specifically Reg. Section 20.2032-3 (b)(1)] made it clear that the landowner must have a non-passive leasing arrangement to satisfy the "qualified use" requirement. IRS personnel have indicated that while a cash lease would fail the requirement, a share lease, even though without material participation, would suffice. However, ERTA included a provision, retroactive to January 1, 1977, which negates this active lease requirement at least when the decedent was renting to a family member. Also, in August 1981, the U.S. Treasury amended the 1980 Regulation to be consistent with the ERTA provision.

be an advantage in a family member participating in place of the retired farm landowner so that full social security benefits can be obtained. Of course, the family member who participates will be required to pay self-employment tax on his net earnings, but this generally will be less than what the retired landowner would pay. The family member could claim a share for the management services provided, and the balance would be paid to the landowner as rent. Of course, the family member who steps in to materially participate may not pay additional social security tax if this person has enough other income from farming or other activities to reach the maximum wage base on which social security or self-employment tax must be paid. An ERTA provision, effective in 1982, suspends the material participation requirement for a landowner retired on social security, yet the land may still be eligible for special use valuation.

Prior to 1982, the landowner could solve this eligibility problem by involving a family in a materially participating way. In the "typical" family farm situation when one generation retires, another already has assumed operation of the farm in some type of business arrangement: tenant, partner, or corporate employee-manager. A family member who is an operating tenant is self-employed in that capacity and may not pay any extra tax even though he is meeting the participation requirement for the retired landowner's farmland estate. It follows from the discussion above that any material participant can employ professional farm management services where needed.

Material Participation and Other Requirements for Special Use Valuation

Federal Tax Law. Use valuation came into the law January 1, 1977, and while not strictly limited to a farm business situation, it is apparent that the family farm was intended to benefit. This alternative to fair market valuation is an election of the personal representative of the estate in which farmland used for farming is a major asset. However, the family members who are heirs or who have a survivorship interest must consent to the election. It is the parties receiving the property which is part of the Federal estate tax gross estate that will benefit and who are required to maintain the property in the "qualified" farming use beginning with the decedent's date of death and to satisfy the material participation requirement. They must contend with a lien that arises by virtue of an estate tax savings and its potential for recapture. A recapture event is the removal of the use-valued farmland from a farming use. The original legislation provided for total recapture up to 10 years following the decedent's death and partial recapture may occur during the five years following the initial 10 years. The new revisions of ERTA, effective in 1982 eliminated the five years of partial recapture.

Qualifications. Qualified real property means property located in the U.S. which belongs to a citizen or resident of the U.S. and is a qualified use, such as the "business" of farming at the date of the decedent's death. Fifty percent or more of the adjusted value of the gross estate must consist of real and personal property which at the decedent's death was in a qualified use (an "at risk" farming) and this property to be use-valued must have been acquired from or passed from the decedent to a qualified heir of the decedent. A qualified heir is a member of the decedent's family who acquired property from the decedent. Further, 25 percent or more of the adjusted value of the gross estate must consist of the adjusted value of real property passing from the decedent to his qualified heir. "Adjusted value" means fair market value of the property at the date of death less indebtedness on the qualified property.

The special use valuation statute lists a "qualified use" requirement for the land to be use-valued. Final IRS Regulations issued July 31, 1980 and subsequent comment by IRS personnel make clear that this requirement is separate from the material participation requirement. The IRS Regulation states that a passive rental arrangement such as a cash lease is not an at risk arrangement since it does not make the land owner's return directly dependent upon production of the land owned and rented. A crop share lease is dependent upon production.

This 1980 Regulation placed the requirement to be "at risk" directly on the landowner. Thus the direct implication was that a landowner cash renting to a son or other family member would make the land ineligible for special use valuation. And this would be the result even though the family member tenant would be satisfying the separate requirement of material participation.

However by August 1981 this "at risk" requirement spelled out in the 1980 Regulation was removed by a provision in the ERTA retroactive to January 1, 1977. Also, the 1980 Regulation was amended to be consistent with the amendment in ERTA.

In short, a family member can satisfy the "at risk" or qualified use requirement just as it was understood before by the wording of the original tax law that a family member could have satisfied the material participation requirement for a decedent landowner. The provision in ERTA permits the estate tax return to be reopened and special use valuation election reinstated if accomplished within six months after August 13, 1981.

If the decedent is not organized in a proprietorship but in fact has stock in a corporation or interest in a partnership, the "qualified use" requirement is viewed differently. A decedent may have cash-leased land to a partnership or corporation and have the land meet the qualified use test if the decedent owns an equity interest (common stock or general partner interest) in the partnership or corporate entity. However, this interest must meet a closely-held business interest test in the Revenue Code [Section 6166(b)(1]. In the case of a partnership, 20 percent or more of the total capital interest must be in the decedent-partner's estate or such partnership has 15 or fewer partners. Stock in a corporation is a trade or business if 20 percent or more of the value of the voting stock of such corporation is included in determining the gross estate of the decedent or such corporation had 15 or fewer shareholders.

To illustrate, a "substantial" stockholder in a farm operating corporation may own land as a proprietorship and cash rent to the operating corporation and still have the land eligible for special use valuation, at least under the qualified use requirement. The material participation requirement would have to be satisfied by the decedent landowner or a family member by an employee agreement with the corporation which calls for activity, which, if viewed in a proprietorship arrangement would be considered material participation.

It should be emphasized that the qualified use requirement is one that the qualified heirs must also satisfy. As explained below, one qualified heir or family member of a qualified heir can satisfy the material participation requirement for one or more qualified heirs. But, all qualified heirs must be at risk under the qualified use requirement. To illustrate: if a brother and sister inherit and are qualified heirs under a use valuation election and if they cash rent to a family member or to an unrelated tenant, the estate tax savings would be subject to recapture.

Provisions in ERTA-1981 modify the "qualified use" and material participation requirements in certain situations. For example, a surviving spouse can apparently leave land eligible for special valuation by using the material participation record of a deceased spouse.[3] Qualified heirs who are spouses, disabled, minors (less than age 21) and full time students referred to as eligible qualified heirs may satisfy the material participation requirement with an "active" management role, but with something less than material participation. A trustee or other fiduciary may provide the needed management in place of a qualified heir who is disabled or a "minor." Further, a two-year grace period is provided after a decedent's death during which a qualified heir's failure to satisfy qualified use requirements will not cause a recapture of the estate tax savings. These changes are all retroactive to January 1, 1977.

A special note is in order concerning the concept of highest and best use and the eligibility of farmland for use valuation. On September 10, 1979 an IRS News Release (IR-2160) indicated that special use valuation statutes and the associated legislative history would not be interpreted as requiring the electing estate to show that a "highest and best use" other than farming existed before eligibility for use valuation to be considered. There was some expectation that a regulation or decision to the contrary would be issued. An adverse position would make ineligible for use valuation any farmland for which the "highest and best use" is farming. Farmland next to a metropolis would likely have a "highest and best use" other than farming while most farmland may appear to have no other practical use than farming. An adverse decision in this regard would make administration of the use valuation statute difficult since the influence of industrial and housing development is a continuum as one moves from city to city.

[3]There is a question whether a new provision actually permits a spouse's "active" or material participation to be added or tacked to the material participation of a decedent spouse when the surviving spouse failed to live five years beyond the decedent spouse.

Methods of Valuation. Two distinct approaches to a special use valuation are provided: (1) the "farm method" and (2) the "five-factor" approach.

The "Farm Method" permits value to be calculated for qualified farmland by using the following formula:

5-year average
annual net cash
rent for comparable soils

divided by

5-year average annual
effective interest rate
on all new Federal Land
Bank loans

The five years over which data must be gathered are the most recent 5 calendar years ending before the year in which the decedent died. Cash rent observations are to be from comparable farmland in the locality of the land in the estate net of the state and local real estate taxes for the particular parcels being considered. For example, if the cash rent net of taxes averages $125 per acre for the preceeding 5 years and the appropriate Federal Land Bank loan rate was 10.0 percent, then the use value would be $1,055 per acre. The fair market value on such land might be $2,500 to $4,000 per acre depending upon the location, fertility, and the circumstances of a sale. Thus, use valuation might bring a reduction of over $1,000 per acre of qualified land in the federal estate tax calculation.

Difficulties may arise in obtaining the cash rent or share lease data from neighbors for the 5 years preceeding the decedent's death. Neighbors may be unwilling to surrender information which is often held in confidence. How many examples of data from each year will be enough to establish an annual average is open for dispute. What will be accepted as comparable to the land in an estate?

As an indication of the detailed information requested by the IRS from a personnel representative for an estate electing to qualify for use valuation, consider item 21 from an "Information Request per IRC section 2032A..." used by the IRS Estate and Gift Tax Division in Indiana:

21. For each comparable farm being used for the special value computation, please provide the following:

a) landlord's name
b) tenant's name
c) any family relationship between the landlord and the tenant
d) years in which the lease was in effect
e) the exact location of the farm, adequate to locate it in a platbook
f) the total acreage rented, broken down into cropland, woods, pasture, and waste
g) any variation in amount of acreage rented over the 5 years
h) any services the tenant performs for the landlord as part of the rental agreement including the type of service, time involved and equipment necessary to perform them
i) any management or operation of the farm by the landlord
j) listing of any equipment, livestock, or improvements provided by the landlord along with a statement of their market rental value
k) the annual cash rents for the 5 calendar years preceeding the year of decedent's death
l) if no cash rents were paid or only partial cash rents, indicate the market value of the crops or produce the landlord received as rent
m) a listing of state and local real estate taxes assessed for each year for which rent is given (regardless of when paid). Breakdown of tax rate should be included.

This question is the documentation requested by the IRS on cash rent data to be used by an estate for the valuation formula illustrated above. It is expected that similar information will be required after 1981 when share rent data (and landowner costs) are permitted to be used. As a practical matter, it may be most efficient to entrust cash rent data collection and substantiation responsibilities to an experienced farmland appraisal with instructions and guidance from the estate's legal counsel. Appraisers have access to lease information because of their experience and association with farm managers in their firm or they personally manage property. Many farmland appraisers have developed a bank of cash rent data in the process of planning for and performing use valuation appraisals. The cash rent data is relevant in the normal course of appraisal work for "income approach" appraisals.

An IRS Regulation indicates that comparability to farmland in an estate will be based on:

1) Similarity of soils as determined by any objective means such as by official soil surveys;
2) Soil depleting potential of crops grown;
3) Soil conservation techniques practiced;
4) Flooding potential;
5) Slope;
6) Livestock carrying capacity;
7) Timber stands;
8) The location of the fields in a given farm;
9) Nature and value of improvements;
10) Proximity to local markets and transportation facilities.

Evaluation of these factors and others that may be relevant would generally be beyond the competence of a person not trained and experienced in farmland appraisal. Retaining an expert appraiser familiar with farms in the community early in the administration of a farm estate which might elect use valuation would be a wise step on the part of an estate's personal representative and the personal representative's legal counsel. An expert appraiser generally is needed for developing an appraisal for fair market value whether use valuation is elected or not. "Sizing-up" the valuation problem for the estate is essential to analysis of the valuation options open in the tax administration of an estate.

It is important to recognize that the appropriate or acceptable fair market value for the entire holding of farmland in an estate may be substantially below what would appear to be the price that could be obtained at an auction or public sale of 40, 80, or 120 acres. Also, the land in an estate may be subject to an option to buy. In fact, the very price at which it can be sold may already be set by prior agreement. If certain conditions are satisfied, predetermined prices at which a transfer is executed in the estate can be imposed for federal estate tax valuation.

Some observers believe that IRS personnel will allow a Federal estate tax settlement on farmland at an amount below the apparent fair market value. This may be true, but it is likely that if it is, it is done in the spirit of a compromise to prevent excess administrative costs to the IRS arising from further contesting the matter. It also may be true that observers base their comparisons for values of farmland in estate tax settlements on current sales forgetting that estates being given a tax clearance currently are for a decedent's estate with date of death valuation dates 18 to 30 months earlier when land values may have been 10 to 30 percent lower. The advice of appraisers experienced in federal estate tax appraisals and lawyers who have experience in settling these matters should be considered well before the estate tax return and the alternative valuation election is due which is 9 months after death, unless the IRS has granted an extension of time for filing.

In the original 1976 legislation, special valuation was not permitted to reduce valuation below fair market valuation by more than $500,000. This limitation was ammended as follows: 1981 - $600,000; 1982 - $700,000; and after 1982 - $750,000. Also ERTA permits timberland to be considered for special use valuation starting in 1982.

In mid-1980 the IRS released data on values reported by executors electing special use valuation. This information shows discounts to fair market value (FMV) by IRS districts. Some examples:

	Discounts to FMV
	%
Indianapolis, Ind.	51
Springfield, Ill.	62
Cleveland, Ohio	49
Dallas, Texas	64
Philadelphia, Pa.	76
Phoenix, Ariz.	59

Table 2 shows the Federal estate tax savings of use valuation for various levels of adjusted gross estate (AGE = gross estate minus debts and expenses of settling the estate) where 80 percent of AGE is farmland and the farmland is use-valued at 50 percent of the fair market value (FMV). Results in Table 2 show the significance of use valuation to heirs of estates of modest and larger AGE's. These calculations reflect the unified credit of $192,800 in 1987. No marital deduction from the various adjusted gross estates is considered. Starting in 1982 the marital deduction may be 100 percent of all the asset values going to the surviving spouse. However, it is questionable strategy for a decedent spouse to leave substantial values eligible for the marital deduction because of the very high estate tax that could arise in the surviving spouse's estate. An additional 1982 change that will determine the decedent farmer's federal estate tax gross estate is the new rule that permits only 50 percent of the value of joint property

Table 2. Federal estate tax before and after special use valuation for selected adjusted gross estates without a martial deduction: 80 percent held as farmland and use valued at 50 percent of fair market value for 1981 and 1987.*

Adjusted Gross Estate			FEDERAL ESTATE TAX					
			1981			1987		
	1981**	1987						
Before	After	After	Before	After	Estate tax reduction	Before	After	Estate tax reduction
250,000	150,000	150,000	-0-	-0-	-0-	-0-	-0-	-0-
500,000	300,000	300,000	108,800	40,800	68,000	-0-	-0-	-0-
750,000	450,000	450,000	208,300	91,800	109,500	55,500	-0-	55,500
1,000,000	600,000	600,000	298,900	145,800	153,000	153,000	-0-	153,000
1,500,000	900,000	900,000	508,800	259,800	249,000	363,000	114,000	249,000
2,000,000	1,400,000	1,250,000	733,800	473,000	260,500	588,000	255,500	332,500
2,500,000	1,900,000	1,750,000	978,000	688,800	289,200	833,200	475,500	357,500

*Results are based upon the unified credit of $47,000 for 1981 and $192,000 for 1987. No reduction is taken for the Federal State Death Tax Credit since that amount or more will be collected by virtually all states' inheritance or "pick-up" tax when the estate tax exceeds the unified credit.

**The reduction below fair market value is limited to $600,000 in 1981 and $750,000 after 1982.

to be included. But the special use valuation remains a very important feature in the estate tax law for farm families as the potential "estate tax reductions" indicate in Table 2.

The Five-Factor method is an alternative to the cash rent data approach (farm method). If cash rental data are not available and all other requirements are satisfied for a use valuation election, qualified real property must be valued according to the following five factors mentioned in the law:

1) Capitalization of expected income,
2) Capitalization of the fair rental value of the land for farmland,
3) Assessed land values in any state which provides a differential or use value assessment law for farmland as closely-held business,
4) Comparable sales...in which nonagricultural use is not a significant factor in the sales price, and
5) Any other factor which fairly values the farm or closely-held business value of the property.

While valuation based on the above five factors is not likely to yield as low a value as with the cash rent method, the five-factor approach applied in Indiana and other states should give a result that removes some of the "speculative value" from the FMV of farmland in estates. Indiana has, effectively, a differential assessment rule referred to in (3) above which would tend to hold down the valuation of farmland. Items (1) and (2) should yield a valuation based on possible current rentals of the land in the farming use which generally yield results below fair market values since the FMV reflects "speculative" value or elements of income other than current rental rates. IRS regulations or rulings have not been issued on the relative weights for the "five factors" nor interpretive Court cases leaving open the possibility that each of the five factors, if applicable, would be weighted equally.

Satisfying Material Participation and Certain Other Requirements. An additional requirement, already mentioned above, is that during the 8-year period ending on the date of the decedent's death, there must have been at least 5 years in which the real property for which special use valuation is sought was owned by the decedent or a member of his family and used for a qualified use by the decedent or a family member and there was material participation by the decedent or family member in the operation of the farm (or other closely-held business) 5 or more years of 8 years immediately preceding death. A family member includes for special use valuation:

1) ancestors and lineal descendants,
2) a lineal descendant of a grandparent,
3) the spouse of an individual in (1) or (2),
(4) the decedent individual's spouse.

An adopted child is treated as a natural child. Nephews, nieces and their spouses are family members.

ERTA-1981 changed the family member definition, effective in 1982, to remove category (2), lineal descendants of grandparents. Lineal descendants of the individual's spouse added an individual's stepchildren. The new definition of a family member with respect to an individual is: (1) ancestors, (2) spouse, (3) lineal descendants, (4) lineal descendants of spouse, (5) lineal descendants of parents (6) spouse of any lineal descendants in (3), (4) and (5). While this new definition adds lineal descendants of a spouse, it has the net effect of removing uncles, aunts and cousins. Therefore, an individual expecting to leave land eligible for special valuation will not do so if uncles, aunts and cousins are included in the transfer arrangements. Further, if a cousin or spouse of a niece is the party intended to satisfy qualified use or material participation requirements for the individual additional adjustment will be necessary.

The public policy notion giving rise to special valuation of farmland in order to reduce the impact of federal estate tax on family farms. Therefore, satisfying the family member status is crucial. In addition, to being permitted to satisfying the qualified use (at risk) and material participation requirements for an individual wishing to qualify farmland, a qualified heirs family member can meet the qualified heirs material participation requirement and can also purchase the land from the qualified heir without causing a recapture of the estate tax savings.

A person may satisfy the family member definition for material participation prior to the decedent's death and not be a qualified heir. A qualified heir is a family member who was given, purchased, inherited, or has a survivorship interest in the qualified property. For example, a nephew may satisfy material participation requirements for an aunt while she is living. The aunt's children may be the only qualified heirs.

At least one of the qualified heirs or a family member of a qualified heir must satisfy a material participation requirement which begins with the date of death of the decedent family member whose estate includes the farmland to be use-valued. Absence of material participation for 3 or more years during any 8-year period ending after the decedent's death triggers recapture (imposition of the additional estate tax) of the estate tax avoided by use valuation or could bar an election to use-value. It is critical that the estate's personal representative and the qualified heirs recognize this rule. The measure of time begins before the decedents death. To illustrate, if the decedent has not (nor a family member) materially participated for any 2-year period in the last 7 years lived, one year of no participation immediately following death would bring about recapture or simply disqualify the election of use valuation even before the IRS would audit the estate tax return which may not take place until 12 to 24 months after death. Therefore, immediate steps may be necessary to develop a materially participating relationship to meet this requirement.

If the party operating the farm is not a qualified heir or a family member of a qualified heir, it may be impossible to rearrange the lease to provide for material participation by a qualified heir. Suppose a tenant who leased from the decedent and is not a qualified heir has a lease which is valid against the estate. If the lease precludes material participation by the lessor or an agent of the lessor who might be a family member, the estate and qualified heirs may be precluded from meeting the material participation requirement. As explained above, if the lease is one providing for cash rent, the decedent's business would fail the qualified use requirement making the land ineligible for use valuation unless a family member was the tenant or the family member was "at risk" as an intermediate party or through a business organization.

Unless the tenant is willing to renegotiate the leasing arrangement to permit a qualified heir or a qualified heir's family member to materially participate, special use valuation could be denied. Also, an individual, such as a nephew, who is a family member of a decedent would not be a family member of that decedent's child or children or spouse who are often heirs. According to the definition of a family member starting in 1982, each individual can include only the descendants of their respective parents. Thus, advanced planning to satisfy the at risk requirement of a qualified use as well as to satisfy material participation is a critical issue.

However, an amendment, retroactive to January 1, 1977, provides a two year grace period after the decedent's death during which a qualified heir is not required to satisfy the qualified use requirement. To the extent any of the grace period is used the 10-year recapture period will be extended that amount of time. Presumably the material participation requirement is not suspended by the two year grace period for the qualified use requirement. As indicated above, material participation does not have to be continuous as long as there is no more than a three year lapse in any eight year period. But in the case of the qualified use requirement any lapse on the part of the qualified heir(s), but for the two year grace period, will cause a recapture. And there is the provision for a family member to satisfy this requirement for a qualified heir for a decedent. Death of a qualified heir during the recapture period terminates the requirement for material participation for the decedent heirs share of the specially valued property.

Satisfying the material participation requirements should not be a problem for "typical" family farm where one generation overlaps with the preceeding generation or immediately succeeds it in farming. In this "typical" situation the decedent was of retirement age and has turned the farm operation over to a son or son-in-law by a leasing arrangement. Since the tenant is a family member, the retired parents' lack of desire or capability for materially participating will not matter. The son is materially participating on behalf of the parents. In some cases, a third generation (i.e., grandchild) may be operating the farm. For larger acreages, several families may be involved.

Only one qualified heir needs to materially participate to satisfy the requirement. Again, a family member of a qualified heir can satisfy the requirement such as a spouse, child or child's spouse. Under the rules of use valuation, one qualified heir can sell his share to another qualified heir without causing a recapture as long as the qualified use (farming) is maintained.

However, all qualified heirs or their guardians must consent to special use valuation. If their is disharmony among the qualified heirs, considerable economic leverage could be applied in return for consent to allow the farmland to be use-valued. A "disgruntled" heir should be planned for in advance of his parents' or grandparents' death. Similarly, the qualified heir who is operating the farm could wield a heavy influence. If no other qualified heir or their family can materially participate, the family may be in special need of his services. Family misunderstanding over gifts and inheritance, which leads to irresolvable disharmony, is a long standing problem. Features of the estate tax law which requires explicit consent of heirs or their legal representatives places a high payoff on good communications and fair treatment within a family.

Where special arrangements are needed to protect the financial interests of particular family members (e.g., first option to buy or credit for investments in improvements on parents' property), business agreement documentation and drafting of appropriate language in wills can be used to take care of these needs.

Owner-operators who die prematurely satisfy the material participation requirement on their own as self-employed persons. The surviving spouse and children of a farmer who has died prematurely may have difficulty meeting the post death material participation requirement. Children may be minors or adults, without farming skills. If a surviving spouse is not capable of operating the farmland personally or sufficiently knowledgeable to enter into a materially participating lease, there may be difficulty in maintaining the qualified use. However, the rules of use valuation permit a family member of a qualified heir to participate on behalf of a qualified heir. Thus, if a widow is the only qualified heir, her child can operate the farm or otherwise materially participate. This rule also includes a brother, sister, parent, grandparent, nephew as an illustration. By definition all are family members of a given qualified heir. Qualified heirs' and family members' spouses may participate in place of a qualified heir.

Several problems concerning the requirement of material participation were solved with ERTA-81 amendments to the special valuation rules. Spouses, minor (under age 21) the disabled and full time students are classified as eligible qualifed heirs who are only expected to meet as "active" management requirement which involves participating in decision making, but does not contemplate te extent of managerial input or authority that material participation requires. Further, the disabled and minor may have the "active" management requirement satisfied by a guardian or trustee, but not an agent. Eligible qualified heir provisions are retroactive to January 1, 1977.

Should a surviving spouse die owning farmland without sufficient time to personally satisfy the material participation requirement, the surviving spouse gets the benefit of the deceased spouse's past material participation.

A great deal of flexibility in meeting the participation requirement exists within a family as defined for use valuation. Further, the qualified use (farming) is maintained and recapture of the estate tax savings is avoided when the qualified property is sold to a family member of a qualified heir. Where family members are interested in acquiring additional land, the inconvenience of operating qualified property or managing it in a materially participating lease may be overcome if a "first option to buy" at some future date is granted. Receipt of an option right generally requires some consideration (value given or benefit forgone) in return for a valid option. Consideration could be performance of a valuable service.

Also starting in 1982, like-kind exchanges of qualified property can be accomplished without causing a recapture or long as the property exchanged for goes into the same qualified use as the property traded away.

Perhaps the most difficult planning situation is for the retired farmer individual with a substantial farmland estate but without children who are actively engaged in farming or if there are farmers in the family, they are at a distant location. The situation might be one of having only daughters, none of whom are farmers, who can readily meet the material participation requirements. Many observers and counselors might dismiss such situations by concluding that use valuation for reducing estate tax was intended only for the "family" farmer and this special legislation must be strictly administered to prevent or discourage investors from buying farmland as an estate tax shelter.

While the policy motivation for special use valuation may have been to reduce the burden of the Federal estate tax for "on-going" family farms, it is not clear that a retired farmer who must wait for a grandson to take over the family farmland should be discriminated against by rigid material participation requirements. A farm family typically has at least one farmer in a generation of primarily off-farm heirs who may benefit from use valuation as long as the farmer, qualified heir (sister or brother or a family member of a qualified heir) remains active in farming. Why should one set of off-farm heirs benefit from a larger net inheritance because of a significantly lower estate tax liability and another set of otherwise qualified heirs be unable to elect use valuation because of failure to satisfy strict material participation requirements? But, where no qualified heir can conveniently participate, the large segment of the family tree available under the family member definition can resolve many of these situations.

In order to help resolve this problem and others concerning material participation, ERTA-81 added a provision for decedents dying after 1982 which in effect suspends the material participation requirement after social security retirement or after disability as long as the decedent was in either status at death. After 1982 the material participation requirement must be satisfied a total of 5 years or more out of an 8 year period ending on the earliest of: (1) the date of death, (2) the date on which the decedent became disabled or (3) the date social security benefits started provided the disability or social security status was continuous until death. With this new provision the eligibility of the land for special valuation can be maintained witout participation on the part of the retired or disabled landowners nor by their family members. However, this rule apparently does not suspend the qualified use requirement which would not permit a passive or cash rent leasing situation. Furthermore, the qualified heirs must meet the requirement to materially participate at least 5 out of any 8 years period ending after death of the decedent. As indicated above, there is a 2 year grace period for the qualified heirs before failure to satisfy the qualified use requirement would cause recapture. There provisions taken together permit, time for a qualified heir (as a family member), who were away from the family farm to return and establish the necessary involvement either as an operating farmer or as a material participate.

It should be emphasized that material participation may be satisfied by a managerial relationship with the land. Farming operations need not be conducted by the material particpant. Further, the Regulation concerning material participation makes it clear that an individual could, if necessary, employ a management consultant and not negate the desired material participation status of the individual. Thus, a material participant could obtain advice from a professional farm manager as a consultant to assist in making decisions with a tenant. It is the conventional professional farm management contract that places the manager between the landowner and tenant, negating material participation.

Information requested by the IRS from the personal representative of an estate electing use valuation in the case of the decedent includes:

a) copies of 1040s for the 8 years ending in the date of the decedent's death;

b) a completed medical consent form;

c) a listing of all hospitals and nursing home to which the decedent was admitted and any doctors who treated him in the 8 years prior to his death;

d) location of residence(s) for the period he was materially participating.

When the material participant is listed as not the decedent, information requested includes occupation, relationship to decedent, residence while alleged to be materially participating, and copies of IRS Form 1040 for the years the party is alleged to have materially participated.

The above information will allow the IRS to evaluate the apparent feasibility of the decedent's alleged material participation given health and geographic location. Further, an examination of the income tax returns will disclose whether the decedent or the party claiming to have been the material participant was reporting self-employment income on Schedule F of the 1040 and paying the self-employment tax required to be reported on Schedule SE.

Material participation regulations emphasize that its occurrence is a factual test. There must be an arrangement either oral or written that requires the necessary activity on the part of the landowner or the landowner's family member. Such arrangements must be capable of proof by objective means. If the IRS finds that material participant has subjected net earnings from the material participation activity to the self-employment tax, the situation is described as having passed the litmus test of participation. While if no social security tax (self-employment tax) has been paid by the individual over the period of participation the presumption is there was not participation. Even though there was failure to pay self-employment tax, the presumption may be overcome if the personal representative for the decedent's estate can factually demonstrate to the satisfaction of the IRS that material participation did occur and why no self-employment taxes were paid by the alleged material participant. If the IRS accepts the explanation, the participant must pay all self-employment taxes found due, plus interest and penalties.

Where the decedent was not personally farming the farmland in an estate electing use valuation in some of the 8 years directly prior to death, this implies the land must have been rented. The IRS requires full information on the tenant including:

a) name;
b) address;
c) taxpayer identification number;
d) relationship, if any, to the decedent;
e) a copy of the lease or other agreement (if oral, an affidavit from tenant(s) covering all the terms of such lease);
f) an affidavit from the tenant(s) describing in detail the nature of the farm activities of the material participant during the 5 years or more of claimed material participation (note: this is to deal with actual activities of the material participant not the obligations of the lease contract);
g) documentation of financial responsibility assumed by the owner or family member and by tenant.

While detailed information is being requested by the IRS, it should be apparent that in those cases where a family member has been renting the decedent's farmland there should be no difficulty establishing material participation. This may be the "typical" situation discussed above. Great difficulties may arise when the material participant is a family member who lives a considerable distance from the land, or is in ill health, or whose knowledge of farming may be suspect, or there are shown to be lease(s) or affidavits from tenants that simply fail to support the technical (although flexible) requirements of material participation.

Matters are greatly simplified when a qualified heir is actually farming the land with respect to the on-going material participation requirement for periods after the decedent's death. Before approving an election for use valuation, the IRS requires a copy of the Form 1040 of the party claimed to have been participating from date of decedent's death up until the time an estate tax clearance is granted which currently may be 2 years after the decedent's death.

Where tenants are involved, it would be wise to include as part of the written lease, the obligation to provide the type of information listed above which the IRS demands in the administration of use valuation elections especially where nonfamily members are tenants. Not only must the lease meet material participation tests on the face, the party must, in fact, do what is required of a material participant. When the IRS requests evidence of such information, a tenant must be approached to supply information in an affidavit for which there may be no obligation to provide. It may be wise to have the tenant document the major activities of the participant with an annual affidavit.

Use Valuation for Corporations, Partnerships, and Trusts. Many family farm businesses involve partnerships, corporations and trusts. Will farmland owned by these legal forms (rather than a sole proprietorship) in which a decedent had an interest be eligible for use valuation? The use valuation statute indicates that it will, but the decedent's interest must be sufficient to meet a closely-held business interest test.

For this purpose an "interest in a closely-held business" means:

a) an interest as a proprietor in a trade or business carried on as a proprietorship;

b) an interest as a partner in a partnership carrying on a trade or business

i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent; or

ii) such partnership had 15 or fewer partners;

c) stock in a corporation is a trade or business if

1) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent; or

ii) such corporation had 15 or fewer shareholders.

Interests held jointly or in common with a spouse may be added to that of a deceased spouse to satisfy the above tests. Also, the stock or partnership interest held by a member of a decedent's family may be added to the decedent's to meet the above tests. Here family includes only one's brothers and sisters (whole or half blood), spouse, ancestors and lineal descendants.

Material Participation in Other Areas of Estate and Income Tax Planning

The business involvement concept of material participation has several other applications in income and estate tax law. A recent addition to the tax law, the "2 percent" rule for calculating equity credit for services in survivorship property for a surviving spouse, just became part of the law on January 1, 1979. This provision was repealed by the ERTA-81, as of January 1982. Repeal of the "2 percent" rule is part of the new rule that requires the automatic inclusion of only one-half the value of all marital joint property in the gross estate of a deceased spouse. This rule will be applied regardless of the contribution of the respective spouse to the equity held in the joint property.

Installment Provisions for Paying Estate Tax. The Tax Reform Act of 1976 included another highly beneficial section providing a procedure for electing to pay the Federal estate tax over a period of nearly 15 years. Interest on the unpaid balance of the tax is set by this new law at four (4) percent. This provision is available for election by the heirs and personal representative of the estate without a showing of any hardship concerning the payment of the Federal estate tax. Further, only interest and no principal necessarily needs to be paid for up to 5 years after the original due date for estate tax on up to $1 million in assets in the estate which were used in what the tax law refers to a "closely-held business." Sixty-five (65) percent of the adjusted gross estate (gross estate less valid deductions: expenses, indebtedness and casualty losses) must be assets used in the closely-held business to qualify for the deferred payments, at 4 percent interest. ERTA reduces the 65 percent to 35 percent for estates of post-1981 decedents.

Two definitions for using this section of the law are important: (1) What is "closely-held"? and (2) What is a "business" in the case of farmer or farm landowners? A "closely-held" business interest is specifically defined in the tax law as:

1) An interest as a sole proprietor;

2) An interest as a partner in a partnership if:
 i) If at least 20 percent of the total capital interest in such partnership is included in determining the gross estate of the decedent; or
 ii) such partnership had 15 or fewer partners

3) Stock in a corporation carrying on a trade or business if:
 i) If at least 20 percent in value of the voting stock of such corporation is included in determining the gross estate of the decedent; or
 ii) such corporation had 15 or fewer stockholders.

To satisfy the 35 percent test, family member interest in the same business will be considered to have been held by the decedent, if a decedent had an interest in two or more closely-held businesses, they may be treated as a single closely-held business only if more than 50 percent of the total value of each separate business is included in the decedent's estate. If a decedent's stock is readily marketable, it will not qualify as closely-held.

It should be emphasized that only that portion of the tax associated with the closely-held, business interest up to $1,000,000 in estate value can be qualified for the 4 percent installment plan (actually up to the first $345,800 of tax less the applicable unified credit). However, another section of the law provides for up to 10 years to pay estate tax on the installment plan where a less stringent test of 30 percent of the decedent's gross estate or 50 percent of the taxable estate are imposed as the amount of closely-held interest needed to qualify. But in this case, the interest rate is the general one on taxes owed to the United States Treasury. The 4 percent, 15-year plan and the variable higher rate, 10-year plan can be used together if there are more than one million dollars in closely-held business assets. The 10-year plan might be used alternatively to the 15-year plan. ERTA repeals the 10-year for those decedent's estate arising arising after 1981.

Of further interest in relation to our discussion above concerns what is a business? Generally to have a business means the conduct of a productive enterprise rather than merely an ownership interest. Revenue rulings in 1975 indicated that crop share lease arrangements would satisfy the "business" requirement for a decedent. Similarly the rulings at this time indicated that a cash rent arrangement would not satisfy the "business" requirement. If the decedent were materially participating as a landowner, the "business" test would be satisfied. What is not clear is whether a nonmaterially participating share lease would meet the "business" test. However, a 1981 private letter ruling from the IRS permitted qualification as a closely-held business where a decedent had leased on shares to a son-in-law who apparently held a non-participating lease. Another 1981 letter ruling indicated that the "business" requirement was satisfied where a family had been participating in the management activity for the decedent who leased on shares.

It seems reasonable to expect that the 15-year plan would be available, other tests being satisfied, where the decedent was "at risk" in a leasing agreement, as described above in regard to the qualified use requirement, without materially participating. Thus, a decedent who was engaged in a share lease, but neither the decedent nor a family member was participating, should be able to leave a farm business qualified for the 15-year plan, but possibly not qualified for special use valuation. Additional regulations are needed to make clear the decedent's obligation to have been operating a business just prior to death for installment plan purposes.

The disposition or withdrawal of assets which constitute the trade or business will accelerate all the unpaid installments in the case of the 15-year plan if 50 percent or more of the value of the closely-held interest (not of the value of the entire business) is disposed of or withdrawn.

Subchapter-S Corporations and Passive Receipts. In 1958 Congress provided a special tax law (Subchapter-S) which allows a small group of stockholders to use a corporation business form. The corporate income is generally not subject to the federal income tax. The net income is subject to tax in the returns of the respective stockholders. The policy behind the introduction of the tax-option corporation into the law was to provide corporate status for a closely-held operating business and not place the stockholders in an environment of double taxation: once at the corporate level and again on dividends. Subchapter-S corporations are restricted in their activities by the Revenue Code provisions for the Subchapter-S or tax option corporation. One restriction is that if more than 20 percent of the gross receipts are from passive sources: rents, royalties, interest, dividends, annuities, and dealings in securities, there is automatic termination of the tax-option status. The "20 percent" restriction was aimed at blocking those who wanted to take advantage of the tax-option corporation with passive income earning investments.

The 20 percent restriction may present a problem for corporations owning farmland that is not being farmed by the same corporate business entity. Will the rent be received by a Subchapter-S corporation owning farmland be counted as passive income? Yes, unless the corporation as an entity is materially participating in the leasing arrangement. If the rent is obtained in the form of cash rent, the revenue ruling on this subject would classify such receipts as passive or investment income. The Internal Revenue Service has ruled that a farm under a material participation share lease will not have rents classified as passive rents for purposes of the 20 percent rule. Participation must be by a designated representative of the corporation. Thus, we have another application of the concept of material participation relating to the generation of farm income.

Numerous farmers have selected the tax-option corporation in the last 20 years, often as an estate planning device. Those farmers and other businessmen who retire with their land or other rent-generating investments (e.g., apartments) in a tax-option corporation may for the first time face the reality of the 20 percent rule. Whether the tax-option corporation is the preferable corporate form should be evaluated in the preretirement years by tax and legal counsel. Of course, if it is considered desirable to maintain the tax-option form while renting out the land, the materially participating lease is a necessity where the corporation has ceased to be an "operating business"--for example, one that farms its own land and perhaps rents from other landowners.

If other family or nonfamily member employees are involved in the corporation to conduct the materially participating activity, a stockholder-employee may retire on full social security benefits without endangering the tax-option status of the landowning corporation. Further, where a family member is involved in the materially participating lease, this should meet the material participation requirement for special use valuation. A question might arise over whether the retired stockholder could continue to work part time for the tax-option corporation with a salary less than the exempt amounts of the monthly and annual tests and with such limited employment receive full social security benefits while doing what is necessary for the corporation to have a materially participating lease. While such a fact situation may be feasible, it may be carefully scrutinized by the Social Security Administration. Unless the retiring party can show a substantial reduction in work and management activity, this situation may come under the heading of a "dubious retirement" discussed above. However, if the retiring party switches from and employee of a farm corporation which owns or leases a line of machinery and performs the full series of crop production activities (tillage, planting, cultivating and harvesting) to part time employment as the active employee for the corporation in a materially participating lease, this should permit a retirement under social security rules. An issue could arise over whether there is under-compensation in the part-time position to avoid the earnings exemption limits of the monthly and annual retirement tests discussed above. Social security representaitves will look for retirement in fact.

Even though the social security field staff may closely examine the retirement of stockholder-employees of closely-held corporations, the corporate form of business may make both retirement and overall estate management more convenient and efficient for the major stockholder-employee.

Personal Holding Company Income. The personal holding company (PHC) is a special federal income tax situation which arises when taxpayers incorporate investments and personal services to benefit from income tax rates on corporate income which are lower than personal rates. This strategy would entail no dividends, but instead accumulation of earnings with the company to more rapidly increase the wealth of the incorporating individual(s).

PHC income can arise when two tax law tests are satisfied:

1) Stock ownership test - more than 50 percent of the stock according to value is owned directly or indirectly by five or fewer individuals; and
2) Income test - if at least 60 percent of the corporation's "adjusted ordinary income" is PHC income.

The PHC income is passive investment income: dividends, interests, royalties and annuities and personal service income if there is an "incorporated talents" situation. Where this situation is identified by the IRS, there is a 70 percent penalty tax imposed on undistributed PHC income. After 1981, the penalty tax is reduced to 50 percent.

In the case of farmland in a regular corporation, this problem of PHC income could arise depending upon what constitutes "rent" for this purpose. Rents are not income for PHC income purposes if:

1) It constitutes 50 percent or more of the corporation's adjusted ordinary gross income; and
2) Dividends paid for the taxable year equal or exceed the amount by which its nonrent PHC income for the year exceeds 10 percent of its ordinary gross income.

A corporation engaged predominately in rental activities may escape PHC status, but if its nonrental PHC income is substantial, it must make taxable distributions of such income. A farmland owning corporation with little or no other activity should not have a PHC problem with rent. But it is possible that less than 50 percent of the income defined for these purposes might be rent received while the remainder of the farm income is from other farming activities. Consider the possibility that a corporation might farm in one area and own land in a remote location and rents it out to a tenant. The tenant might be a family member running a separate farm business. What can be done to avoid the PHC income problem from the rent? Tax law has developed that if this rent would otherwise cause the PHC penalty tax, if the farm income is obtained through a materially participating lease, then the income will not be defined as "rent" for PHC purposes. Again participation is the key to avoiding an important income tax problem.

Income in Respect of a Decedent. Another application of the concept of material participation relates to classification and taxation of what were the decedent's income flows. Income in respect of a decedent (IRD) is income which was very close to being earned at the time of death of the party to whom it would have belonged. A familar example would be the last paycheck. Crops and livestock sold after death but allocable to the period prior to death is income in respect to a decedent.

IRD must be included as part of the estate for Federal estate tax, plus it is taxable income. But to avoid double taxation, a special income tax deduction is allowed the taxpayer who reports the IRD. This deduction the increment of estate tax because IRD was added to the gross estate.

Farmland owners who are materially participating in their leasing arrangements at death leave production and rights to income that is not treated as IRD but is handled as other capital assets and receives a basis adjustment according to the prevailing law.

Generally, there is a free, step-up in income tax basis to the value of the asset for estate tax purposes. For example, 50,000 bushels of corn might be valued at date of death of $2.75 per bushel. The $2.75 becomes the basis for figuring taxable income when the corn is sold. If the corn is sold for $3.00 per bushel, there is 25 cents a bushel gain which is taxable income to the recipient. If the corn belonged to a share leasing but not a materially participating landowner, the reportable gain would be $3.00 rather than 25 cents per bushel sold. But, the extra estate tax due to the $2.75 corn in the decedent's federal estate tax return is an income tax deduction to the recipient of the corn sales income.

Soil and Water Conservation Expenses. If a farmer elects, soil and water conservation expenses may be treated as currently deductible expenses up to 25 percent of gross income from farming in any year. Expenses exceeding 25 percent of gross income may be carried forward to future years within the limitation of 25 percent of gross income from farming in each such year. But, to be eligible for this income tax deduction, the landowner must be in the "business of farming." The landowner who share rents, or owner-operator who incurs the conservation expense, is entitled to the deduction. The usually less desirable alternative for the landowner who is cash leasing is to capitalize the expenditure, increasing the basis and reducing capital gain when the owner sells the property, but generates no current income tax relief. A landowner who receives a "fixed rental" whether it is in cash or crops is not in the "business of farming" unless he materially participates by virtue of working on and managing the farm.

OTHER PUBLICATIONS

The following publications may be obtained from your county Extension office or from AGAD Building mail room, Purdue University, West Lafayette, Indiana 47907:

Federal Gift and Estate Tax Changes: Explanation, Comments and Planning for the 80's, EC-548. Estate and Financial Record in Estate Planning, EC-521. Indiana Laws for Understanding Your Estate: Planning and Probate, EC-519.

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